

BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

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IN THE MATTER OF: :

CONSENT MARKETS, TARIFFS AND RATES - ELECTRIC :

CONSENT MISCELLANEOUS ITEMS :

CONSENT MARKETS, TARIFFS AND RATES - GAS :

CONSENT ENERGY PROJECTS - HYDRO :

CONSENT ENERGY PROJECTS - CERTIFICATES :

DISCUSSION ITEMS :

STRUCK ITEMS :

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834TH COMMISSION MEETING

OPEN MEETING

Commission Meeting Room
Federal Energy Regulatory
Commission
888 First Street, N.E.
Washington, D.C.

Wednesday, July 9, 2003

11:05 a.m.

APPEARANCES:

COMMISSIONERS PRESENT:

CHAIRMAN PAT WOOD, III, Presiding

COMMISSIONER NORA MEAD BROWNELL

COMMISSIONER WILLIAM L. MASSEY

SECRETARY MAGALIE R. SALAS

ALSO PRESENT:

DAVID L. HOFFMAN, Court Reporter

P R O C E E D I N G S

(11:05 a.m.)

CHAIRMAN WOOD: Good morning. This open meeting of the Federal Energy Regulatory Commission will come to order to consider the matters which have been duly posted for, actually an hour before this time and place. But nonetheless, please join me in the pledge to our flag.

(Pledge of Allegiance recited.)

CHAIRMAN WOOD: I'd like to welcome everybody and turn it over to Madam Secretary.

SECRETARY SALAS: Good morning, Mr. Chairman. Good morning, Commissioners. The following items have been struck from today's agenda since the issuance of the Sunshine Notice on July the 2nd. E-3, E-12, E-17, E-18, G-3 and G-16.

Your consent agenda for this morning is as follows: Electric items E-5, 6, 7, 8, 9, 10, 11, 15, 16, 21, 22, 23, 24, 26, 27, 28, 30 and 32. Gas items G-4, 5, 6, 7, 8, 9, 10, 12, 13, 14 and 15. Hydro items H-1 and H-3. Certificates C-1, C-2 and C-3. The specific votes for some of these items are G-15, Commissioner Brownell dissenting with a separate statement, and H-3, Commissioner Massey dissenting with a separate statement, and Commissioner Massey votes first this morning.

COMMISSIONER MASSEY: Aye except with respect to

H-3, on which I am dissenting.

COMMISSIONER BROWNELL: Aye, noting my dissent on G-15.

CHAIRMAN WOOD: And I vote aye.

SECRETARY SALAS: The first item for discussion this morning is A-3. This is the summer energy market assessment report, a presentation by Jolanka Fisher accompanied by Steve Harvey.

MS. FISHER: Good morning, Chairman. Good morning, Commissioners. My name is Jolanka Fisher, and I'm from the Office of Market Oversight and Investigations. I'm here this morning to present our office's 2003 summer energy market assessment.

A lot of things are changing in the energy marketplace as we head into the summer of 2003. As open and competitive energy markets evolve, participants have taken steps towards transparent market designs and trading platforms. Furthermore, investments over the last few years in power plants now provide higher reserve margins across much of the country. Market participants are actively addressing concerns about the quality of natural gas price reporting.

And finally, energy market participants are beginning to rebound from a period characterized by adverse financial conditions.

(Slide.)

Nevertheless, our office tends to focus on the challenges. The three primary challenges we see facing the energy marketplace this summer a tight supply-demand balance in the gas market, with effects on natural gas and electricity prices; demand response, which can help moderate some of these price increases, is still missing from electricity markets; and finally, financial conditions, which have reduced the number of companies active in the energy marketplace, has effects on the efficiency of operations.

(Slide.)

Turning first to natural gas prices, this figure shows that the current situation in natural gas prices is that they are considerably higher than they were in the past. The blue part of the presentation shows historical prices, and the green part shows the consensus view of prices in the future.

It's not a prediction, but it gives us signals of where things are going in the future.

(Slide.)

Turning to the next slide, this represents the role of natural gas in setting the price in regions across the country. As you go by region, for instance, turning to California, 95 or 91 percent of the time gas is on the

margin, which means it's the last unit switched on and therefore sets the market clearing price for most units in the region. But the role of gas varies by region. So if you turn to ECAR, you see that only 23 percent of the time is natural gas on the margin.

The fact that natural gas is on the margin 20 percent or 90 percent does not reflect the fuel mix in the region. It only reflects the last unit turned on, but it has an important role in setting the price, particularly in regions in organized electricity markets. In utility markets, it's some average of this price.

(Slide.)

The next slide looks at natural gas prices throughout the country, and it's fairly striking that throughout the nation in most regions gas prices have nearly doubled since last June.

(Slide.)

But when you turn to electricity prices, you see that the effect is somewhat more mixed. For instance, in PJM West, the fourth line, prices have actually gone down since last summer. This is in part because of a mild winter but also because of, as we saw before, the relatively small role of natural gas prices in that region.

But if you turn to the West, NP-15 and SP-15, you see that natural gas prices have a large effect on

electricity prices.

(Slide.)

To address high natural gas prices, market participants are taking action. We've seen in the last few months a significant response in the form of new drilling which will, in the longer term, have an effect on gas prices.

For the Commission's part, the Commission has been speeding up certification of pipeline certificates, and in particular has done so in the Rockies to bring more of Rockies gas to the marketplace.

(Slide.)

As we turn to the next slide, relatively small reductions in demand can have an effect on prices in the electricity marketplace. This is true in all markets, but as we look at the supply curve in electricity markets, it's quite pronounced in electricity. As you reach high levels of demand, prices escalate rather substantially.

What we have here is an actual supply curve from an organized market, and what we've done is taken the blue line represents inelastic demand, which means no response to prices, which is fairly accurate for most markets across the country. And we've added just the smallest amount of demand response.

So just by a few customers pulling back on demand

in high priced hours can really dramatically lower the price for all market participants, not just those that have reduced consumption. In this schematic, a small reduction in demand lowers prices by \$400.

(Slide.)

Demand response really has a lot of effects. Small amounts of demand response in electricity markets reduce peak prices, moderates price volatility, reduces peak loads, reduces congestion and improves local reliability. It reduces supplier market power. And finally, it moderates long-term price levels by lowering spot market prices.

(Slide.)

Unfortunately, given all of these effects demand response will play a limited role this summer. In organized electricity markets, demand response was only zero to 3 percent in those markets. In markets without organized electricity markets, data are not as reliable, but they tend to show very little demand response is available.

(Slide.)

To address the lack of demand response in electric markets, market participants, particularly ISOs, have taken aggressive action by promoting demand response, particularly in regions of concern for the summer, like New York City, Long Island and Southwest Connecticut.

As reflected in your decision to incorporate

demand response in electricity markets, you've shown that demand response is an important part of organized electricity markets. In addition, you've required market monitors to report on demand response, which keeps the focus on demand response going forward.

(Slide.)

Finally, I turn to financial conditions. Current weak financial conditions have dampened energy market liquidity. Markets tend to work fast when they have many different participants pursuing many different strategies but tends to create the lowest price to meet customer and supplier needs. Said in a different way, many suppliers give customers many choices, and as they use those choices, they can find the best options.

(Slide.)

In the longer term, the weak financial conditions and lack of liquidity have effects, including reductions in available capital for infrastructure investments and storage injection.

Weak financial conditions highlight the need to ensure the conditions of nonregulated affiliates do not harm those of regulated utility customers.

(Slide.)

To address weak financial conditions, market participants are taking actions. In the industry, they are

doing what they need to, to restructure their companies so that in the long term going forward they are better able to compete in the marketplace.

In addition, they're using innovative techniques to increase efficiency, such as credit clearing. In addition, in January, FERC co-sponsored a technical conference on credit clearing to help move the industry forward.

The Commission has taken action to address weak financial conditions by doing several things to oversee corporate cash management policies in order to protect customers.

(Slide.)

The last slide just gives information on where further information about the 2003 summer energy market assessment can be found. The presentation will be on the Web site at www.ferc.gov, and then the complete report will be available on the Web in a few weeks.

Are there any questions?

CHAIRMAN WOOD: I just wanted to say thank you for the presentation. And, Nora and Bill, anything you want to add or query?

COMMISSIONER MASSEY: I had a question. I think I saw in this morning's Gas Daily that EIA has readjusted its estimate for gas prices for 2004, readjusted downward

substantially. I mean, it's still in the \$4 range. And I just wondered if that's reflected here or is that too new information?

MS. FISHER: I can answer the second part of the question. That's not reflected in the prices, in the futures strip shown in the first part of the gas presentation. It reflects what market participants thought about the market a few weeks ago.

MR. HARVEY: What we've seen kind of recently has been a bit of weakening in the production area gas prices. Most recently, actually a little strengthening in the price. But it's extremely what we call volatile. It's moving around a great deal right now, which is probably -- is something we tended to expect based on the level of storage inventory at this point. That creates greater volatility in the market as there's uncertainty as to exactly how that'll play out.

But with the relatively cool early summer weather and substantial increases in injection into storage for gas, we think things have calmed down a great deal, but they'll continue to be relatively volatile and probably jump around a fair amount.

They got as low as below \$5 briefly at Henry Hub. They're back up into the mid-\$5 range right now.

COMMISSIONER MASSEY: For 2004 though I think

they adjusted their projection to somewhat over \$4, but I think they reduced it by like 60 cents.

MR. HARVEY: And that's very consistent with the futures curves that we presented earlier. The futures market really is indicating that a lot of the current level of prices is very much a this year kind of, expected to very much of a this year current storage situation with some weakening over time.

However, even with that futures weakening, it doesn't look like the '90s, that was the point Jolanka was really making early on.

COMMISSIONER BROWNELL: If I were to take away a couple of message points here, this is a reflection of some fundamentals in the marketplace. I didn't hear market manipulation mentioned. It's a function of, in spite of a lot of encouragement from this Commission, we still don't have demand side as an active part of the marketplace.

And then third, which I'd like you to speak about, either one, that is the lack of liquidity. Because I think that you reference it a little bit in terms of investment in infrastructure, but it has more implications than that I think. And as people are exiting the trading business, I think longer term we need to think about some of those impacts. So could you describe that? And if I've missed a message here, certainly correct me.

MR. HARVEY: Liquidity is an issue that we consider very important, and sort of at its heart, liquidity in a market like this has to do with the ability for anyone, a buyer or a seller, to go in and transact readily at an available market price.

One way of thinking about that is are there enough buyers and sellers in the market. And as Jolanka pointed out earlier, that generates choices that allow people to make choices that are good for them, and as they collectively make those choices, that gets us to an efficient price and a price that really is high enough to sustain investment and low enough to meet customers' needs in an effective way.

In the context of the overall financial condition of the industry, there are many companies who have come out of being active in these markets, and so there are fewer of them working in the markets than there were in the past.

That probably has had two effects. One is you have less people doing strange and potentially concerning things, but you also have fewer people actually interacting in an effective way.

And so we believe it's important to keep the attention on how important it is for companies to be actively engaged in these markets, to be participants, to help produce an effective and an efficient competitive

market for energy across the board. And in the end, that really helps customers by getting to that price that makes an effective tradeoff between investment and the needs of the customers.

COMMISSIONER BROWNELL: So that our work in terms of the technical conference's work with the CFTC potential new rules is not intended to drive people from the trading business, but is intended to create a framework where we can comfortably understand that business but encourage people to participate. Is that?

MR. HARVEY: Absolutely. A lot of being effective in those markets is important. People not behaving correctly in those markets is also something that's important. We need to look at both of those things, and a good healthy market will have a lot of robust activity. It makes it harder to manipulate prices. It makes it harder to do a lot of those other things because you just simply can't set up. There are too many people interacting in too many different ways for those things to happen.

COMMISSIONER BROWNELL: Thank you.

CHAIRMAN WOOD: Again, I appreciate the focus of the report, and I think we're more comfortable with documents. They really are a look-ahead, heads-up report as to what we, from our side of the fence, are focusing on, and what we intend to kind of feed into our actions and those of the industry, including our monitoring, which we're looking at now.

I appreciate the particular focus on the demand response, because it's one that we have clearly got a great bully pulpit on, but we do clearly have to. It's not ours alone to control, if at all.

I do notice that one of the things you flagged there is our forthcoming proposed rule on small generator interconnections as a way to decentralize some of the sources of power on the grid and allow individual customers to respond by not necessarily shutting off, but changing their resource to a local one, which may not necessarily be one that ought to be running full time, but can certainly knock the tops off the peaks and allow for some real efficient grid management.

So I was pleased to see that referenced here, but just in general, I appreciate -- because I just saw your presentation here, in a nice summary form, for the first time this morning.

But I appreciate that you have woven into the

garment, as it were, all the initiatives that we've been doing. Some people may look at them as being scatter-shot, but they really are a part of a coherent message, which is to try to, as I think Nora's question was pointing, to restore some semblance of order to a free market.

And I appreciate that attempt to not just report data, but to weave it into a story and to analyze it and to put it in on a continuum with the important activities going on in the industry, and the both additional, important activities that are going on here at the Commission.

I look forward to getting the full document out and letting people look at it. I think it's timely to discuss the summer assessment in our peak meeting of the summer.

MR. HEDERMAN: Mr. Chairman, if I could just briefly note another very important leader in developing this document was Lisa Carter Murwer, who is out ill today, but I don't want to let her contribution go unnoticed.

And there were dozens of other people who I encourage you to look in the back of the final report. As you note, we are doing this and we still haven't managed to get the public presentation before Summer, but I want to assure the market participants and the Commission that the guts and insights of this were in place and being used by our monitoring efforts for a couple of months already.

Thank you.

COMMISSIONER BROWNELL: It would be interesting, since these are new tools that we're developing, perhaps, if in the document itself, we had some kind of feedback mechanisms, so we could analyze what the market thinks of the report, how they are using it, what's missing, what's not.

MR. HEDERMAN: There is, both in this one and the last one, there is an e-mail address that people sent feedback to. Thank you.

SECRETARY SALAS: The next item for discussion this morning is E-1, Reliant Energy, Mid-Atlantic Power Holdings, with a presentation by David Katham, Gregory Berron, Mike Goldenberg, and David Mead.

MR. KATHAM: Chairman Wood, Commissioners Brownell and Massey, on April 2, 2003, Reliant Energy, Mid-Atlantic Power Holdings, tendered for filing, a Complaint pursuant to Section 206 of the Federal Power Act against PJM, alleging that the energy offer price caps on certain on certain of its generation facilities in PMJ operating areas, subject to chronic transmission constraints, were not just and reasonable.

Reliant requested that the Commission change PJM's offer cap to one based on the ISO New England proxy CT mechanism for the use of facilities. The draft Order before

you finds that Reliant has not sustained its burden of showing that the current offer caps in the PJM region are unjust and unreasonable.

Reliant did not provide data to show that its units in PJM are not recovering fixed and variable costs, nor did it show that PJM's mechanism fails to provide its units, or units in general, a reasonable opportunity to recover their costs or that the offer caps provided insufficient revenues to create an incentive for new entry.

The draft Order therefore denies Reliant's Complaint. The draft Order also finds that PJM should reexamine its mechanism to ensure that it's providing appropriate compensation for mitigating market power for must-run services and requires PJM to make a filing by September 30, 2003, either to revise its tariff or to justify its existing provisions.

COMMISSIONER BROWNELL: I'd just like to comment, and then kind of ask for some further work to be done. I'm troubled by this issue, and troubled because it's an issue that's bubbling up in each area of the country.

I'm also troubled that while the working group has been working since sometime in, I think, November of 2002, and it's been an issue since 2000, and, frankly, if markets are to work effectively, I don't think that that amount of time is responsive.

So I join in Exelon's comments that we really do need to get an answer in here by September 30th. I would like, frankly, all of the stakeholder groups in the ISOs and RTOs to really evaluate the process here.

I'm really concerned. A year or two -- the market, frankly, is dysfunctional. We don't know what's happening with market participants.

But, secondly, because this issue is continuing to come up in various ways, I would really appreciate it if we could ask the Staff, perhaps a cross-functional group led by OMTR, with OMOI and OGC to really look at the RMR issue, to look at the different solutions in the marketplace.

I'm not sure that I frankly fully understand why there's a different solution in each region. I don't understand why there tend to be different definitions in each region, and I'm concerned that we're creating some dysfunctions and some seams in the marketplace.

We are certainly creating for market participants who participate in more than one region -- I think we need to get our arms around this before we have any number of complaints coming in and we're confronted with this issue.

So, if my colleagues agree, perhaps we could charge the Staff with doing some work on this issue.

CHAIRMAN WOOD: I think that's merited, Nora. I know the Staff has been working additionally on an RMR

paper, due to some concerns, I think, that have come from all our Staffs recently.

I think it's time to kind of bring that effort up to a higher level. We're got a very old RMR decision from the California market. We've got the rehearing of the Devon case from New England.

And there is a related RMR case that was struck from today's agenda, E-17, I think it was. We've got this issue from PJM. It is related to one of the core problems of the white paper, which is market mitigation, market monitoring. That's one of the eight things that we're going to see in every market, and I fully expect that this will be probably one of the maybe two chief ones that we will focus on with the PJM stakeholders and market participants on the August 28th White Paper Tech Conference that we've set up for Wilmington.

I think one of the down sides to having a more flexible approach on SMD is that we don't really decide this all collectively, but these issues really do merit a more comprehensive national look for the reasons you laid out, Nora, and I think it's time -- it's almost past time that when we've got this many cases bubbling up, for us to look at a policy that we're going to pursue here.

Clearly we want to make sure that we look at the best practices of what works, but we want to make sure that

what works is not just what works for the short term, but what works over the long term.

You and I have had this discussion since we've been in here, but, you know, the immediate response to stem the California market is not really the precedent we need to have for healthy, long-term balance of market forces and market controls where competition fails to exist, such as we see here on the next Order that we'll look at, which is market mitigation in the more constrained regions of New England.

I think all these dots are out there. I think we need to start connecting them in a comprehensive way, and I think your request for really -- I guess I would call it more than a thought piece, but really an internal working document, which I would hope we'd make external, so we'll get feedback on that.

We do have coming in, Bill Hederman, on the 3rd and 4th.

MR. HEDERMAN: Yes, the market monitors will be in August 3 and 4.

CHAIRMAN WOOD: That's a good group to start with. You need to say, okay, you guys are in different markets, you're on the front line.

There response may be rather to mitigate than to not mitigate, so we need to say that on meeting day, we

balance that, because we do want the monitor investment everywhere. But I think it's timely be talking about these issues now, with them coming in, and we can perhaps broaden that to be outside to think about these policies before we start implementing them in individual cases.

COMMISSIONER BROWNELL: I'd see kind of the work that we need to do is, first of all, some data gathering and compare and contrast, because we have a continuous series of fine-tuning and mitigation Orders and different kinds of approaches.

I think we need to kind of look at some very empirical data that says who's doing what and why. Then we can kind of figure out what is the impact and then see why we have so many approaches and what I think the market participants perceive the impact of those to be.

I think you're right; there needs to be a balance between mitigation and sending the right long-term price signals and making sure that market participants are, in fact, allowed to recover their costs. I think, in the aftermath of California and the political ramifications of volatility, the tendency is to mitigate everything.

And if our intention, long-term, is to create fully-functional markets supported by adequate infrastructure, I think it's time to stop and take a look. So I think there are a couple of pieces to it, and I think

it involves kind of a multi-group task group within the Agency and then some kind of an opportunity for comment. Sorry, Bill.

COMMISSIONER MASSEY: What we seem to have is sharply idiosyncratic rules, depending on the region and that's just the way it is right now. But I think we ought to move toward an approach that is common, I think, if we can, over time.

So both of you have stated my views on this very well. We're always trying to achieve this mysterious, somewhat magical balance between, in a market-based environment, between pricing incentives, incentives in the marketplace, and a well-functioning market that attracts needed investment, and also ensures that prices are within a zone of reasonableness. It seems to me that that's what we're about here in virtually all of our policies right now.

I think we ought to be moving toward a system of metrics -- and I think we are -- for evaluating markets that are common all over the country and an approach on this issue that it may not have to be precisely the same in each region, but is more where the regions have more in common than they do differences.

So, that is what I hope we move toward, and I look forward to looking at this issue more generically. But

I support this Order.

CHAIRMAN WOOD: Okay, let's vote.

COMMISSIONER BROWNELL: Aye.

COMMISSIONER MASSEY: Aye.

CHAIRMAN WOOD: Aye.

SECRETARY SALAS: The next item for discussion is E-4, ISO New England. This is a presentation by Daniel Tudor, accompanied by Helen Dyson and John McPherson.

MR. TUDOR: Good morning, Chairman and Commissioners. In the draft Order before you, ISO New England proposes to implement first-level mitigation in the New England market.

The proposal addresses market power, when a pivotal supplier has market power in a specific hour. The proposal further addresses a specific structural problem that targets only those suppliers that obtain market power as a result of these structural problems.

The pivotal supplier will provide for evaluation of the conduct and impact stuff on pivotal suppliers, energy suppliers, and offers for mitigation during unconstrained periods.

The pivotal supplier is defined as a market participant whose aggregate energy supply for a particular hour is greater than the NEPOOL supply margin. ISO New England will designate pivotal suppliers, prior to the day-

ahead and real-time market clearing processes.

For each hour in the day-ahead and real-time markets, the draft Order accepts the plan. The draft Order also directs ISO New England to include in its quarterly reports to the Commission for a period of one year, for pivotal suppliers, all instances of mitigation, including the price bid, the mitigated bid, the duration of mitigation, the system load, and the available supply at that time.

Further, the draft Order directs ISO New England, in its next annual State of the Market Report, to assess its market design, including its mitigation measures. Thank you.

CHAIRMAN WOOD: Thank you. We kind of said it on the last one, but this one, I think, is the second iteration of the market mitigation regime that we approved for New England. It is similar to the one in New York, and I think it has distinguishing characteristics, but it's appropriate here.

I think you and I were probably more on this the first time that they came in and made a specific case. They have done so. This is the specificity that we actually don't have in the New York market, and perhaps we're going to look at that with the New York market again, to make it more specific, to link it to a structural -- the pivotal

supplier.

That's been a good mechanism since we talked about it two years ago this Fall, about assessing the market power. Clearly, that's really been followed here. So I think it's not over, it's not under; it's balanced; it's Goldy Locks, so I'm ready to vote for it.

COMMISSIONER MASSEY: Aye.

COMMISSIONER BROWNELL: Aye.

CHAIRMAN WOOD: Aye. Thank you all.

SECRETARY SALAS: The final item for discussion this morning is a joint presentation of Items G-1 and G-2, both related to El Paso Natural Gas Company. This is a presentation by Ingrid Olson, accompanied by John Carlson, Robert Petrocelli, Elizabeth Zerby, and Ellen Schall.

CHAIRMAN WOOD: Ms. Olson.

MS. OLSON: Good morning, Mr. Chairman and Commissioners. G-1 and G-2 are companion draft orders. I have implemented reallocation of capacity on the El Paso Natural Gas Company system to restore reliable firm service in El Paso and to put into place proper economic incentives to encourage the development of additional infrastructure.

G-1 generally denies a request for a rehearing of the Commission's May 31st and September 20th, 2002 orders. It affirms the Commission's prior conclusion that full requirements or FR contracts on El Paso must be converted to contract demand, or CD contracts, effective September 1, 2003.

Furthermore, G-1 explains that after conversion of the FR contracts to CD contracts, the FR customers will no longer be bound to take all their transportation service from El Paso, but will be free to contract with other pipelines for additional service. This will encourage the development of additional infrastructure as needed.

G-1 also affirms the Commission's prior ruling that capacity that will become available from El Paso's power-up project must be included in the initial allocation to the converting FR shippers. The order clarifies that until the power up project is operational, El Paso must hold in reserve additional replacement capacity consisting of

turnback capacity to ensure that El Paso can meet its service obligations to these shippers. G-1 does grant a rehearing with respect to reallocation of costs among FR shippers.

On rehearing, the draft order concludes that such reallocation is unnecessary to restore reliable firm service.

The prior orders in this proceeding directed El Paso to allocate CD quantities to the converting FR shippers based on each shipper's monthly demand over the 12 months ending August 31st, 2002.

El Paso filed its report detailing the results of the conversion on December 3rd, 2002. G-2 finds that El Paso's report generally complies with the Commission's direction in reallocating capacity. That because the order grants rehearing with respect to the reallocation of costs among FR shippers, El Paso will have to file new tariff sheets to implement the change.

Both orders point out that the CD levels assigned to the FR shippers will meet their current usage needs. The two orders complete the process of assigning contract demand rights to the former FR customers.

CHAIRMAN WOOD: Bill, anything?

COMMISSIONER MASSEY: Yes, I have something to say. In these orders, the Commission puts in place are a

much more rational system of capacity allocation on El Paso. Actually, this process was initiated nearly three years ago, in the context of El Paso's filing in compliance with Order Number 637. Those proceedings revealed significant dissatisfaction with El Paso's capacity allocation methodology.

El Paso was imposing pro rata capacity reductions on CD customers, while continuing to serve all the requirements of the full requirements customers. CD customers believed that they were paying for service that they were not receiving. And so the Commission ultimately initiated a Section 5 proceeding.

This situation resulted from a 1996 settlement that established a unique capacity allocation methodology on El Paso. El Paso's CD customers pay a reservation charge based on their contract entitlements. They must reserve and pay for the capacity that they want and need. El Paso's other customers, the full requirements, or FR customers, pay a reservation charge based on their billing determinants established in the 1996 settlement.

The reservation piece has remained unchanged, despite the fact that many of the FR shippers' demands have grown significantly in the intervening years. El Paso has gone from a pipeline flush with capacity -- I remember years ago in which El Paso actually made a filing to recover

stranded costs on the pipeline. What year was that, by the way?

MR. PETROCELLI: 1995, sir.

COMMISSIONER MASSEY: 1995. They were facing a capacity glut, but now they are a pipeline that is capacity constrained much of the time. CD customers nominate quantities for which they are paid reservation charges, only to find that El Paso cannot transport nominated volumes and must make pro rata cuts due to capacity constraints on the system.

The Commission determined that this split capacity allocation scheme that arose from the 1996 settlement was broken, and was no longer just and reasonable, and we gave the pipeline and its customers opportunities over several months to negotiate a solution that would put the CD customers and the FR customers under the same rules for capacity allocation.

There were lots of meetings, and lots of negotiations, lots of discussions, but they could not agree. So in May of 2002, the Commission imposed the capacity rationalization process that we largely reaffirm here today. That was 13 months ago. Today's orders deny a rehearing of the major elements of the May 31st, 2002 order.

We do, however, want to be sensitive to the desire of the full requirements customers to preserve a

measure of the flexibility that they had under the 1996 settlement, while recognizing the need to ensure that the CD customers get the service for which they are actually paying.

The Commission pegged the FR to CD conversion at the level of each FR customer's 2001 peak usage, and I support that, but can the staff give me their rationale for that measurement, using 2001 peak usage?

MR. PETROCELLI: What we attempted to do as a group, sir, is define the current usage pattern on the system, and we did that using a traditional rate methodology of current test period and actual usage.

We looked at the 2000 and the 2001 NCP. Then we updated NCP with each customer's own peak usage, and we updated that to the latest 12 months, of August 2002, when we issued the September 10th order. We tried to reflect the usage patterns of the system as of the date that the original order went out.

COMMISSIONER MASSEY: For most of the FR customers, how does today's usage compare with 2001 usage? Is it roughly the same?

MR. PETROCELLI: For the most part, I think it is the same. There has probably been some increases and some decreases.

COMMISSIONER MASSEY: Depending on the customer?

MR. PETROCELLI: Yes, and the season, and the climate.

COMMISSIONER MASSEY: But we chose that measurement because we thought that it was fair and balanced.

MR. PETROCELLI: I think the concept was to use the latest usage patterns at the time that the Commission issued its order.

CHAIRMAN WOOD: I noticed that in Appendix D of the G-2 order, which is the actual allocations, I think that an exception that was described in the footnote for while it is different, all the allocations are in many cases a substantial bump up from what the peak day use was in 2001. What is the reason for that?

MR. PETROCELLI: Yes, sir. The way the billing is determined that is in the NCP, and the actual allocated NCP, show that we have in fact allocated all of the customers' amounts in excess of their 2001 NCP, and/or their billing determinants.

The basic reason for that is that we allocated all of the capacity available on the system, including the newly added line 2000 capacity, and the newly proposed power capacity. When you add all of those together, and come to the available capacity, we are able to on a monthly basis meet each customer's NCP. That is a monthly number.

COMMISSIONER MASSEY: There is one issue, or there may be more than one, but the one that I want to focus on is that we do grant the rehearing requests by some FR shippers with respect to the reallocation of costs, and we decide not to reallocate costs among the FR shippers at this time. Can the staff speak to that issue?

MS. OLSON: On reconsideration after reviewing the request for a rehearing, we determined that this order

-- the Section 5 finding is very narrow and is intended just to restore firm reliable service on El Paso, and to remedy the unjust and unreasonable allocations of capacity. We concluded that it was not necessary to reallocate costs among the FR customers to achieve that goal.

COMMISSIONER MASSEY: So we are trying or we are requiring a different methodology here for allocating capacity. Clearly we are solving a serious problem, but we are trying to be as surgical as we possibly can. That is the way that I look at that. So we are not reallocating those costs.

MS. OLSON: That's right, exactly.

COMMISSIONER MASSEY: I am pleased to vote for this order. Not everyone will like it, but I think at the end of the day the capacity allocation process pursuant to this order will be rational and fair, and in line with the way that other pipelines allocate capacity.

COMMISSIONER BROWNELL: Commissioner, you summarized the order well. I just would like to add that it is orders like these when you know how Solomon feels. I think that there will be people who are unhappy with this order, but one of the things, it speaks to two things, I think.

One is that planning becomes critically important in terms of developing adequate infrastructure. In some of

the hearings that we had on this, we talked about the phenomenal growth in the western region, and how that was somehow not anticipated.

I think the second thing is that we are bringing some rationality, as well as equity, to this allocation process. That brings it in line with the operational rules of other pipelines, and that is critically important.

So it is an imperfect world. I think that we have in fact been surgical. We don't like to tinker with settlements, but this was a settlement that by anyone's measure was unsustainable. It was simply unsustainable.

So we have limited ourselves to fixing I think the most important problem. It is important for people to remember, and it is difficult. What we really need to do is to get on with life and build a sufficient infrastructure, and send the right economic incentives, which appear to have been lacking in the settlement that existed. So I am also pleased to support this order, although a difficult challenge I think for all of us.

CHAIRMAN WOOD: You all are so articulate. I guess that is why they always make me go third, so I don't have to add anything. But I just want to add for you guys who have been fixtures in my office, and I am sure all of the rest of our offices for the last year-and-a-half on this, it is excellent work.

It is why there is a regulatory body here to basically walk the beat, and you folks have done a nice thoughtful job. A lot of good give and take. I appreciate your candor and personal bias, but also your very find attention to the detail that is necessary to look through what is really a very major business decision here.

If we do it right, it won't affect people. It will just incent people to move in the right direction, but I think we have got to be prepared that this is going to have some impacts that most of which we have anticipated, if not all, and so you have done a good job, and thank you for walking along this path with us.

It has been a long couple of years, but the delay in time has also given people time to read just as well. So there is a benefit to that. On the market participant side, as they say, what goes up on September 1st, this one is now officially going forward.

COMMISSIONER MASSEY: If I could say that one of the reasons that this has taken some time is the staff is much more painfully aware as I am that we wanted to give the parties an opportunity to try to work things out if we could. There has been lots of notice that the Commission has early on chartered a course here, and indicated the direction we would like to head in.

Ultimately if there is no negotiated solution, we

have to step up to the plate and make some hard choices.

That is what we did here.

CHAIRMAN WOOD: Let's vote.

COMMISSIONER MASSEY: Aye.

COMMISSIONER BROWNELL: Aye.

CHAIRMAN WOOD: Aye. See you in two weeks. The meeting is adjourned.

(Whereupon, at 11:55 a.m., the open session was concluded.)